Investment Beliefs

Addressee and purpose

This paper is addressed to the Pensions Officers (the "Officers") and Pensions Committee (the "Committee") of the Lincolnshire Pension Fund ("the Fund"). It sets out updated wording for the investment beliefs section of the Investment Strategy Statement following training and discussions with the Committee and Board on 17 February 2022. Our intention is that the Officers and Committee review the revised wording so that it can be formally adopted by the Fund.

This paper should not be released or otherwise disclosed to any third party except as required by law or regulatory obligation without our prior written consent. We cannot be held liable for any loss incurred by a third party relying on this paper without such permission.

Introduction

In the following sections, we suggest updated wording for various parts of the Investment Strategy Statement (Investment Strategy, Investment Beliefs and Responsible Investment Beliefs) based on the views expressed by the Committee and Board. New or updated wording has been <u>underlined,</u> and deletions have a ~~strike through them~~.

We have also set out proposed actions and next steps where relevant (*in italics*) to illustrate how these could impact on the Fund's investment strategy, asset allocation, and governance activities. We are not proposing that the wording in italics be included in the Investment Strategy Statement.

The Fund's beliefs should be revisited on a regular basis to ensure they remain appropriate. It is also important that these beliefs are reflected in the underlying portfolio of assets and in the Fund's ways of working.

We recommend that the following is read in conjunction with the existing Investment Strategy Statement as it contains additional context on the Fund's asset allocation and approach to manager engagement and voting activities.

Investment Strategy Statement wording

The following is taken from the current Investment Strategy Statement unless underlined or in italics. This includes the comments which expand on the beliefs.

INVESTMENT STRATEGY

The primary objective of the Lincolnshire Pension Fund is to provide pension benefits for members on their retirement and/or benefits on death, whether before or after retirement, and for their dependents.

The Committee aims to fund the benefits in such a manner that, in normal market conditions, all accrued benefits are fully covered by the value of the Fund's assets and that an appropriate level of contributions is agreed by the employers to meet the cost of future benefits accruing. For employee members, benefits will be based on service completed and final salary (pre 1 April 2014) and/or the accumulation of individual years built up through the career average pension scheme (post 1 April 2014) and will take account of future inflation increases. This funding position will be reviewed at each triennial actuarial valuation, or more frequently as required.

Investment Beliefs

These beliefs form the foundation of discussions, and assist decisions, regarding the structure of the Fund and the strategic asset allocation. In addition, they are used to ensure that new members on the Pensions Committee understand previous investment decisions taken. It is recognised that environmental, social and governance (ESG) issues are important to the long-term success of the Fund, and the Committee aims to integrate consideration of these issues into all aspects of the Fund's investment arrangements.

Belief 1: The Fund should take no more investment risk than is necessary to have a reasonable chance of achieving its objectives, and only where the Committee believes it will be rewarded over the longer term.

It is recognised that investment risk is needed in the Fund to generate the required returns, however this needs to be considered on an on-going basis to ensure it is appropriate (i.e. not too high or too low) given the Fund's objectives.

Belief 2: Funding, contribution requirements, and investment strategy are linked; as the funding position and contribution requirements change, the level of investment risk should be adjusted accordingly.

~~As the Fund moves closer to full funding (i.e. 100% assets to meet liabilities on an appropriately prudent assumption of investment return) then it is expected that the level of risk will be adjusted accordingly.~~

The Committee's aim is to strike a reasonable balance between 1) building up a pool of assets to meet members' benefits when they fall due, 2) maintaining contribution requirements at a reasonable and affordable level, and 3) minimising investment risk.

Actions and next steps

The Committee discussed the potential to de-risk the investment strategy considering the anticipated improvement in funding level at the 2022 valuation. It was also noted that there would likely be an increase in the Primary Contribution Rate which appeared to be somewhat inconsistent. On balance, the Committee's view was that it may be appropriate to target a slightly higher expected return so that the Primary Contribution Rate can be maintained at the current level.

The committee also discussed what would constitute a minimum risk asset for the Fund considering the investment objectives and anticipated approach for setting assumptions (discount rate in particular) for the 2020 funding valuation. It was agreed that a diversified portfolio of return seeking assets would provide the best 'match' for the valuation discount rate going forward.

The role of the Fund's existing investments in UK gilts and investment grade corporate bonds was considered. The Committee's view was that, while these assets had traditionally been viewed as 'low risk' investments and they had provided a good level of protection in a falling interest rate environment, their future role in the portfolio should be reviewed as part of the forthcoming strategy review.

Belief 3: Investing in illiquid assets provides opportunities for enhancing returns, and investing in alternative asset classes helps to diversify the Fund structure.

The Committee accepts that by "locking away" funds for longer periods of time, the Fund should expect to be compensated for the lack of liquidity in the form of higher expected returns. However, it is understood that this is not suitable for all the assets in the Fund.

The Fund's investments should be diversified by combining assets with different risk, return and liquidity characteristics, whilst maintaining realistic expectations about the potential for sources of return to become correlated under market stress.

The Committee believes an appropriate portion of the Fund should be invested in non-core asset classes, i.e. alternative assets, to provide diversification and reduce overall volatility of returns.

Actions and next steps

The Committee discussed the Fund's capacity to invest more in illiquid assets, noting that the Fund is expected to remain cashflow neutral, or relatively close to it, for the foreseeable future, and that it should be possible to benefit from the Fund's ability to invest for the long-term. It was concluded that an increased allocation to illiquids should be considered as part of the forthcoming strategy review, possibly funded by a reduction in the allocation to UK gilts and/or investment grade corporate bonds.

There was also discussion of the Fund's relatively large allocation to listed equity, and the risk/return trade off from further diversifying into alternative, more income generating, assets. It was noted that it may be possible to maintain, or even enhance expected returns depending on the type of alternative asset(s) considered, and that this should be reviewed as part of the forthcoming strategy review. It was noted however, that there is a good level of diversification at company level within the allocation to equities, and that equities are still expected to provide the most attractive balance between risk and expected return; the view therefore was that listed equity should remain the largest allocation within the portfolio.

Belief 4: Passive and active management both have roles to play in the Fund's structure; passive to deliver low cost asset class exposure and active to add potential value, understanding that active managers' success should be measured over a reasonable timeframe.

The Committee believes that active managers can add a return premium over investment markets, over the longer term, but accept that this has a cost. Therefore, this is balanced with allocations to passive management to produce market returns at a very low cost.

~~**Belief 5: Environmental, social and governance (ESG) issues are important to the long term success of the Fund.**~~

~~The Committee believes that it should act as a responsible owner across all of its investments and that ESG issues and considerations have a financial impact on the long term performance of the Fund. The Fund works with managers and other organisations to understand the potential impact of the risks and opportunities relating to ESG matters.~~

Actions and next steps

The essence of Belief 5 has been incorporated into the wording introducing the investment beliefs (see above) on the basis that the Committee views this as an overarching principle which has implications for all aspects of the Fund's investment arrangements.

Belief 6: Although fees and costs matter, it is the expected return net of all fees and costs that should be the Committee's focus, however it is <u>important that the value provided by an investment is commensurate with its cost</u>.

The cost of accessing different asset classes and different management styles must be understood to ensure that the Fund is obtaining value for money, however the expected net return is the most important consideration when assessing investment opportunities and monitoring investment performance. The Fund expects its managers to have signed up to the Cost Transparency Code, and it also participates in fee benchmarking to assess the fees being paid relative to other pension schemes.

Responsible Investment beliefs

These beliefs form the foundation of discussions, and assist decisions, regarding the structure of the Fund and the strategic asset allocation. In addition, they are used to ensure that new members on the Pensions Committee understand previous investment decisions taken.

Belief 1: Companies with a responsible ESG policy are expected to outperform companies without an ESG policy over the longer term.

The Committee believes that companies that have well developed ESG policies will generally provide better long-term performance than those companies that have not considered ESG factors in their business.

Actions and next steps

The Committee discussed tilting the portfolio more towards investments with a specific ESG focus, and the view was that consideration and investment in line with this belief should now be part of 'business as usual' for the Fund's investment managers. It was recognised that the Committee should regularly review the managers' approach and the resulting balance within the portfolio, and that a policy of constructive and proactive challenge may be appropriate.

The suggested approach here is that the Committee, with support from the Officers and Hymans Robertson, proactively set the agenda for engagement with the Fund's managers and Border to Coast. The intention is to:

- *reduce the total amount of information the Committee receive;*
- *focus reporting and discussions on ensuring that delegated activities are being carried out comprehensively and effectively and that they are adding value; and*
- *provide constructive challenge to improve processes and procedures.*

We envisage that for both periodic (quarterly) reporting and the ESG part of manager discussions:

- *the Officers/Hymans would propose and agree with the Committee an appropriate topic in advance. This could be taken from the Fund's voting and engagement guidelines or the UN Sustainable Development Goals;*
- *the Officers/Hymans would identify one or two relevant (ideally controversial) companies within the portfolio to use as specific examples; and*
- *managers would then be asked to comment on, for example, the original and ongoing investment rationale, how the relevant ESG considerations were taken into account, what engagement and voting activity has been undertaken, what success has been achieved, and the value added for the Fund.*

By looking at specific examples (which are ideally not chosen by the managers), it is expected that the Committee will gain a deeper understanding of what the managers and Border to Coast are doing on their behalf, and be better able to provide constructive challenge.

Belief 2: The Committee considers that company engagement, rather than disinvestment, <u>is</u> the better approach to fulfilling their responsible investment objectives. However, should a company not respond to engagement, disinvestment <u>should be considered</u>. Disinvestment on a whole sector basis is not within the Committee's beliefs.

Disinvestment is a blunt tool that is not believed to provide the best outcomes over the medium to long term. The Fund will, through its managers and other organisations, engage with companies to bring change, but will consider company disinvestment if engagement fails.

<u>While disinvestment on a whole sector basis is not considered appropriate, the Fund will not invest in companies whose products do not comply with the Geneva Convention.</u>

Actions and next steps

The Committee discussed the information they receive in relation to the managers' engagement and voting activities. It was noted that a lot of work is being done on behalf of the Committee by managers, Border to Coast, and the Local Authority Pension Fund Forum (LAPFF) in this area, and that a huge amount of information is available. It was recognised however that additional challenge may be appropriate to ensure that this activity is comprehensive and effective, and that disinvestment is being considered when appropriate (this would be covered by the proposed approach outlined above).

Belief 3: Climate change and the expected transition to a low carbon economy is a long-term financial risk to Fund outcomes.

The Committee believes that climate change risk and the transition to a low carbon economy should be factored into asset allocation decisions and also investment decisions by managers to reduce the long term financial risk, but also to take advantage of the opportunities that may be available.

Actions and next steps

The Committee discussed putting in place a target date for the Fund's investments to be Net Zero in terms of greenhouse gas emissions. Additional targets were also discussed, including a carbon budget linked to a maximum temperature rise, to help assess progress and determine if addition action is required. It was noted that there was a risk, both financial and reputational, that the Fund could be left behind if no action was taken to address climate change considerations.

It was considered that a 2050 target would be appropriate for the Fund, noting that this date had been set by both Border to Coast and Lincolnshire County Council. It is not anticipated that immediate action will be taken to adjust the Fund's assets specifically to align with a Net Zero journey plan, although this will be taken into account if any changes are considered as part of the forthcoming strategy review.

The position of the Fund, and the potential need to take action, will be reviewed later in 2022 or early 2023 following publication of a Net Zero journey plan by Border to Coast, and a review of the Fund's ESG metrics once appropriate reporting is available.

Belief 4: The Committee should focus on meeting its financial obligations to pay benefits to members.

Financial considerations should therefore carry more weight than non-financial considerations. The main objective of the Pension Fund is to ensure that it is able to pay benefits to its members as and when they fall due. Therefore, financial considerations will be at the forefront of any investment or asset allocation decisions.

Actions and next steps

The Committee's view was that a 'financials first' approach remained appropriate. However, it was recognised that this did not mean pursuit of higher returns regardless of ESG considerations; a balance needs to be achieved.

The Committee discussed adopting an approach where the Fund would seek to make a positive impact through its investments, across the range of ESG considerations, subject to targeting sufficient returns from the assets. The scope to reposition a proportion of the portfolio to have more 'impact' can be reviewed as part of the forthcoming strategy review.

Belief 5: The Fund's active investment managers should embed the consideration of ESG factors into their investment process and decision making.

The Committee believes that the consideration of ESG factors when making investment decisions should not be an add-on but should be embedded into the whole investment selection process. Any active managers appointed by the Fund will be expected to evidence this.

Actions and next steps

The approach to engaging with managers and Border to Coast outlined above is also relevant here.

Belief 6: The Fund should collaborate with other investors if it could have a positive impact, and also engage with them and investment managers to better understand ESG risks.

The Committee believes that the Fund has a stronger voice when working with others, be it Border to Coast Pensions Partnership, Local Authority Pension Fund Forum (LAPFF) or any other organisations. The Fund will work with them and the investment managers to ensure that it understands the ESG risks and how best to address them. It is considered that the Pensions Committee represents the views of the Fund membership and, in addition, the views of the Local Pension Board are taken into account as part of their review of this document.

Summary

This paper sets out suggested wording to update the Fund's Investment Strategy Statement and investment beliefs. Subject to confirmation from the Committee that it accurately reflects their beliefs and the discussions which took place on 17 February, the next step is to update the Fund's official documents.

We look forward to discussing this paper with the Committee at their forthcoming meeting.

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February 2022
For and on behalf of Hymans Robertson LLP

General Risk Warning

Please note the value of investments, and income from them, may fall as well as rise. This includes equities, government or corporate bonds, and property, whether held directly or in a pooled or collective investment vehicle. Further, investments in developing or emerging markets may be more volatile and less marketable than in mature markets. Exchange rates may also affect the value of an overseas investment. As a result, an investor may not get back the amount originally invested. Past performance is not necessarily a guide to future performance.